Are You Making This Massive Mistake With Your TFSA Freedom Fund?

Description

According to Warren Buffett, the greatest investor of all-time, the number one rule in investing is this:

Don't. Lose. Money.

Like many of you, I've heard this Golden Rule of investing a million times before. But I've never really appreciated what it means until now.

What Buffett means by this rule is as simple as it is powerful. He's urging investors not to put themselves into a situation where losing money is likely, even if the upside potential is huge.

After all, a loss of 50% of your invested capital means you must double what's left to get back to break-even. A 75% loss is even worse, with an investor needing a 300% gain just to get back to where they were originally. I'll stop there, since it just gets more and more depressing as the original loss increases.

These kinds of missteps can add years to your retirement journey. They really can be the difference between having a comfortable early retirement and trying to scrape together a decent amount of income once you can no longer work.

Embracing this mentality is doubly important in your TFSA, too. The compounding power a well-funded TFSA will produce over a few decades is nothing short of remarkable. If used right, your TFSA could easily be worth $1 million, if not more. That's almost enough for a good middle-class retirement right there.

But if you mess up inside your TFSA and lose money, it's doubly hard to get back ahead. You're limited with your contribution room. It's not as simple as throwing more money after the problem.

With all this in mind, how should you invest? I have a few ideas, including a stock I think does a great job of protecting your cash.

A new TFSA mindset

Like a lot of things in life, embracing this investing philosophy is easier said than done. It looks relatively simple on the surface but it's tricky to execute.

A key part of this strategy is to look at potential downside first, then worrying about upside.

One common mistake is made by value investors who look at a company that is slowly shrinking. They're enticed by the company's low price-to-earnings ratio or price-to-book value, without even thinking of the consequences. Why is this company shrinking? Can it be easily fixed? The answer to the second question is almost always no or else management would have already done something.

Once we've narrowed down the investing universe to organizations that are growing, the next step is to figure out what a stock's intrinsic value is. As long as shares trade under that value, it can be considered. After all, a growing company should increase intrinsic value over time.

A real-life example

It doesn't take a genius to see that **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) is undervalued.

All one needs to do is look at the traditional metrics used to value bank stocks. Shares trade at a mere 11 times trailing earnings and 10 times forward earnings, which is quite attractive for a stock that looks poised to add about 5% to its bottom line next year. Shares trade at 1.4 times book value, a little lower than where bank shares usually trade. Even Scotiabank's dividend yield is higher than its peers', checking in at a robust 4.8%.

Even if growth slows in Canada over the long term, the company's Latin American assets should continue to expand. The region still has a fragmented banking system, which should drive organic growth. And the economy itself should continue to expand at a nice pace. Put those two variables together, and we have an excellent growth story.

After examining all that, I don't see a world where Scotiabank shares can lose me a significant amount of money. In fact, I'd argue shares are trading under their intrinsic value, a level that should grow with earnings over time. I'd be buying today if I didn't already have a full position.

The bottom line

Risky energy or marijuana stocks might seem like a good idea, but you're violating one of the most important investing rules when you speculate on those names. Remember that before you put your TFSA to work, and you'll end up richer in the long run just by avoiding mistakes.

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